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## **Discussant's Response to Some Historical Auditing Milestones; An Epistemology of an Inexact Art**

**Horace G. Barden**

Ernst & Ernst, Retired

My initial invitation to participate in this symposium asked if I would undertake to discuss a paper entitled, "Some Historical Auditing Milestones—How They Got There, What They Portend for the Future." (The authors of the paper subsequently proposed the revised title as it appears herein.) I wondered somewhat about how they happened to extend the invitation to me. I finally concluded they must believe that I am one of the few old practitioners still tottering around who was actually on hand as the profession encountered many of the events in the last forty-five years that are now considered milestones. The organizers of the symposium probably figured that if I had been there at the time these events occurred, I should at least be able to pass on the first part of the question, namely, "How They Got There," and if so, they would take a chance on my viewpoint when it came to distilling what the events portend for the future.

My active interest in accounting began in 1924, and it has been my principal interest since 1927. Accordingly, I was on hand and watching most of the events that Gene Brown and Roger Salquist have listed as historical auditing milestones. I think I can answer some of their questions as to whether they have omitted any important events. I should also be able to clear up some of their uncertainties as to causes underlying certain of the milestone events, their importance at the time, and the resultant influences on the profession.

I don't believe the combined efforts of the authors and myself are going to uncover any hitherto unknown facet of our heritage, or structure any new theory leading to a greater understanding of our present state of affairs. I do believe that our combined efforts might enhance understanding of the past, and give a wider perspective of today's moment in auditing history.

### **The Problem**

I really doubt that I would have undertaken the authors' task by attempting the route of "an epistemological study." I shall admit that I quietly stalked that word "epistemology" for two or three days after my initial shock of finding it in the subtitle of their paper. I finally got up the courage to sneak into the library and pounce on it in an unabridged dictionary. According to the knowledge so recently obtained, I shall attempt to keep my discussion of their paper within a framework of interpreting the milestones in terms of the knowledge to be gained therefrom, its limits, and its validity.

I turn first to the question of whether we are, in fact, dealing with an inexact

art, irregular in its evolution, without articulated goals, but developed principally within a framework of pressures from within and from its external environment. I believe there is little argument about the notion that auditing is an art in the sense that it involves the systematic application of knowledge in performing certain actions to accomplish a desired result. It is definitely a service function, performed for business enterprises, with its indirect benefits flowing to management and other users of financial reporting. Like accounting itself, it is pragmatic in nature and its evolution has been shaped and modified to meet the needs of the various interests which it serves. Auditing theory has not been developed from a precise set of postulates which have been tested conceptually to deduce principles.

Drawing generalizations from detailed observations is inherent in the methodology of auditing. The same is true of the manner in which most theory of auditing has been established. This process has, nevertheless, developed a rather rigorous applied discipline, with a reasonably good organization of its underlying knowledge. Because of the pragmatic nature of auditing, its evolution has obviously taken place without very many specifically articulated goals which can be identified by milestones of planned accomplishments. Instead, we might better look at the historical events in its evolution as *landmarks*, from which new courses have been plotted in the development of auditing.

### **Auditing Theory and Practice vs. Accounting Principles**

Some of the real milestones and landmarks in auditing history have been obscured somewhat because many people fail to distinguish auditing theory and practice from the development of accounting principles. The accounting profession has carried the primary responsibility for the latter for many years. It has found its attempts to develop authoritative pronouncements on accounting principles fraught with many pitfalls and with much unfavorable criticism from many directions. This has overshadowed much of the steady development of sound auditing theory and practice which has been taking place on a truly professional basis. I hope my discussion of the Brown-Salquist paper will demonstrate this more clearly. Much of the development has taken place quietly and discreetly within the profession in the same type of atmosphere in which the auditor exercises judgments in the confidential work required in carrying on his services.

### **The Ordering of the Events**

The authors state they are fearful of committing errors of commission or omission by basing their observations on a sequential inventory of important publications and events which seems to them to lack order and logic. I can see how this approach might seem tenuous without some first-hand knowledge of the cause and effect relationships which would help rationalize the occurrence of the events.

In the final analysis, they select two approaches to their study of events, the "era" ordering of events, and the "macro" approach of ordering things in terms of the "major socio-econo-technological environmental influences." The two methods are used to test the validity of their selections to some extent. Reviewing these two orderings, I find myself relating more closely to the "macro" ap-

proach. I have some difficulty with their classification of audit history milestones by eras, as to the timing and the descriptions of some of the eras.

I shall comment on the milestones selected under both means of ordering which the authors use, but I find it easier to take them up in about the order of time in which I observed them. I think that most of the milestone events were well understood as to cause and effect relationships by leaders in the profession at the time they occurred, even though the documentation of their understandings appears principally in the form of internal professional development rather than in published writings. I find that I need very little hypothesizing to recognize a few clear-cut landmarks that have had continuing monumental effects on the development of the profession.

### **The Industrial Revolution and Expansion of Public Ownership of Business**

Auditing was a matter of relatively little concern until the time of the industrial expansion that occurred in the nineteenth century. Auditing for internal purposes might have expanded somewhat as business enterprises grew in size so as to assure management of proper accountability for liquid assets and the adequacy of internal controls, but the significant effect of the industrial revolution was the expanding public ownership of business enterprises which began in the early 1900's. This, combined with the expanding use of credit, brought about the concept of general financial reporting as the essential route through which to monitor the stewardship of management. These developments caused the auditor to expand his primary objective from that of providing assurances on internal accounting controls, to that of monitoring management's external reportings for the benefit of creditors, shareholders, and other outside users of financial information.

The environmental influences of the period of expanding size of business enterprises and public ownership induced what was truly an era of emergence, as the authors have designated in their ordering of the milestones by era. The growth and recognition of the auditing profession during this period was not particularly exciting. Historical milestones such as the first CPA laws, formations of professional accounting organizations, and the early attempts to formulate authoritative pronouncements on general financial reporting and auditing, all reflect orderly progress in meeting the need of the financial community of that time. The advent of income taxation added to the professional stature of the auditor. His knowledge of income taxation was necessary for auditing company liabilities, and his knowledge about the determination of income as the basis for the new tax naturally caused his clients to turn to him for his professional advice in this area. The authors might have noted this event as the beginning of a fifty year controversy between the budding accounting profession and the legal profession. The history of that controversy, incidentally, is replete with evidence of just how persevering accountants can be when they set their mind to achieving well-articulated goals.

I find it difficult to obtain much of a reading prior to 1929 on the "new public voice" of the "large base of investors" whose supplications, together with those of corporate creditors, were causing increasing numbers of corporations to elect auditors. It seems to me that the Accounting Objectives Study Group, which was formed by the American Institute of Certified Public Accountants

some forty years later, is still seeking to get readings on that same old public voice of the large base of public shareholders.

### **The State of the Art at the 1929 Crash**

I would extend the era of emergence through 1929. The crash of the whole economy certainly was the landmark ending the first period of expanding public ownership in business. As to the state of the auditing art, I find a pretty clear picture in the booklet "Verification of Financial Statements" published in May of 1929, some six months before the crash. (As an aside, the booklet was available for 10¢ per copy.) This booklet was the American Institute's revision of the original publication by the Federal Reserve Board in 1917. The sub-title described the booklet as a method of procedure for the consideration of bankers, merchants, manufacturers, auditors, and accountants. The booklet contained some twenty pages describing the audit procedures considered appropriate at the time for "verification of assets and liabilities at a given date, verification of the profit and loss account for the period under review, and (incidentally) an examination of the accounting system for the purpose of ascertaining the effectiveness of internal check." The booklet concluded that, "If the auditor is convinced that his examination has been adequate and in conformity with these general instructions, that the balance sheet and profit and loss statement are correct, and that any minor qualifications are stated, he may issue a certificate," to the effect that he has examined the statements and that he certifies that in his opinion they set forth the financial position and results of operations. The audit instructions are evidence that a considerable amount of detailed checking was considered necessary at that time, but that it was not mandatory to confirm receivables and have contact with physical inventory-taking.

Many of the large firms still hired "temporary help" for their "busy seasons" in order to handle the large volume of detailed auditing work being done at that time. The rank and file of their staff organizations contained relatively limited numbers of university graduates. About twenty universities in the United States offered courses for a major in accounting, and there was considerable difference of opinion between professional accountants and the academic field as to what the content of the courses should be.

### **Beginning of a New Era: Foundations of Modern Auditing Concepts**

Brown and Salquist set 1929 as the beginning of an era of "consolidation" which lasted through the early 1940's. They mention the public reaction to the stock market crash as bringing on the federal regulation of securities beginning in 1932-1933, and the Ultramares decision as two outstanding milestones in both their era and their macro approaches to auditing history. Considerably later, under their listing of broad social changes influencing the evolution of auditing, the authors classify the formation of the APB as evidence of the profession's increasing assumption of responsibility for the shaping of their own destinies and responding to social needs.

I combine the state of the art in 1929 with Ultramares and the SEC to place a different interpretation on the importance of these events and the extent of their influence on the profession. These events combined to cause the develop-

ment of modern concepts of auditing and the profession's initial assumption of responsibility for shaping its own destinies, all back in those troubled days of the 1930's. Within the framework of this new era of professional development, I can see several landmarks that I believe should be given greater recognition than that accorded by the authors.

**A Theoretical Base for Auditing.** The need for improved general financial reporting which was highlighted by the 1929 crash of the securities markets and the deep economic depression which it triggered, gave rise to the beginning of cooperative efforts between the accounting profession, as represented by the then American Institute of Accountants, the investment community, as represented by the stock exchanges, and industry, as represented by the Controllers Institute. These groups were later joined by representatives of the newly-organized Securities and Exchange Commission. Agreements reached in a series of correspondence between the New York Stock Exchange and the AIA during the period of 1932 through 1934, gave birth to the first generally accepted concepts of accounting principles and auditing theory. These concepts were embodied in the agreed form of short-form auditor's report which is used today with very much the same substance.

The theoretical base for auditing as we see it today is reflected in these features of the short-form auditor's report:

1. Financial statements are basic representations of management, and management has primary responsibility for them and for maintaining an adequate system of internal controls.
2. There is a body of generally accepted accounting principles which, if applied consistently, produces accounting information from which to prepare financial reports fairly presenting financial positions and results of operations.
3. The auditor operates in an environment of examining management's financial statements and rendering his professional opinion thereon, after carrying out such auditing procedures as he considers necessary and in conformance with generally accepted standards of performance.

These basic concepts of financial reporting and auditing were agreed upon in 1934, as a *foundation* for improvement in the format and quality of general financial reporting even though the agreements reached at that time did not attempt to document the generally accepted accounting principles and the generally accepted auditing standards.

I believe that *this* landmark of the middle 1930's was the point at which the profession really accepted the full responsibility for shaping its own destinies. The Chief Accountant of the SEC had been issued an order by the Commission at that point to establish the meaning of the term, "generally accepted accounting principles," and to issue an authoritative pronouncement on them. He had received the Commission's approval, however, to withhold any such action on his part, with the understanding that the AIA would set up the needed machinery to proceed with the issuance of authoritative pronouncements on both generally accepted accounting principles and generally accepted auditing standards.

The Institute did begin work on these two projects through its Committee on Accounting Procedure. Progress was slow and many of the proposals for developing accounting principles and auditing standards met with delays and

controversial actions by the Institute's governing body and its membership. Little had been accomplished when, late in 1938, the infamous McKesson & Robbins case came to light. The entire financial community, and particularly the stock exchanges and SEC were shocked to realize that, in almost ten years since the 1929 crash, relatively little progress had been made in improving the reliability of financial reporting. The immediate action prompted by this event was the Institute membership's approval in 1939, of "Extensions of Auditing Procedure," which made mandatory the confirmations of receivables and physical contact with inventory-taking.

### **Restructuring the Accounting Profession**

Brown and Salquist recognize the McKesson & Robbins milestone in their "consolidation era," and in their listing of regulatory and legal influences on auditing evolution. I accord a great deal more significance to the event. To me, it was the beginning of an era of consolidation for the profession rather than the end. It could be designated better as the end of a period of "conflict and uncertainty" rather than designating that era as beginning in the 1970's as the authors do. I consider the lasting consequences of the McKesson & Robbins landmark to include the restructuring of the profession and the laying of the groundwork for the extensive internal educational and professional development programs of the Institute.

**Separating the Development of Auditing Standards from the Establishment of Accounting Principles.** The real shock of McKesson & Robbins to the leadership of the Institute was the realization that if they were really going to shape their own destinies, they would have to restructure the organization to overcome the cumbersome procedures which had caused them to bog down in attempting to carry out responsibilities they had undertaken some five years earlier. The result was a revision in their charter to enable establishment of "senior technical committees" which could speak authoritatively for the Institute without going through the lengthy processes of approvals by its governing body and membership. The Committee on Auditing Procedure was formed to deal with matters relating to auditing standards and procedures. The Committee on Accounting Procedure was designated to deal with accounting principles and their implementation. They were each charged initially with the respective responsibilities to develop authoritative pronouncements on auditing standards and generally accepted accounting principles.

You are all familiar with how the Committee on Accounting Procedure has fared since that time, eventually being replaced by the expanded concept of the Accounting Principles Board in 1959, and now about to be replaced with a new entity which is expected to relieve the Institute of some of the basic responsibility for the development of principles which they accepted, somewhat by default, in the 1930's. As I noted earlier in these comments, the attention that has been focussed on the difficulties of establishing principles has overshadowed a great deal of the progress that has been made in the field of auditing. The formation of the APB is designated by Brown and Salquist as a milestone in their era of professionalism and in meeting some of the broader social challenges of the times. The event really has had very little cause and effect relationship on the profession's auditing standards or procedures.

The restructuring of the early 1940's went beyond acceptance for developing auditing standards and accounting principles. The foundations were laid at that time for expanding the recognition of three basic functional areas in which accountants render professional service: auditing, tax consultation, and management advisory services. The Institute began formulating goals toward refining its organization so as to expand its services to members and to the profession generally in areas of, (1) examining and qualifying those seeking to enter the profession, (2) furnishing continuing educational and professional development programs in all three branches of accounting services, and (3) improving the quality of professional services by maintaining an appropriate code of ethics governing the professional behavior of its members. These are the hallmarks that have come to distinguish accounting as a profession rather than as a trade or an art.

**Auditing Standards.** World War II slowed progress, but the first big payoff of the restructured Institute's programs went on display in 1948 with the publishing of the tentative statement, "Generally Accepted Auditing Standards, Their Significance and Scope." I class this as a monumental milestone—marking the achievement of a carefully planned goal. It is a true landmark in auditing history in the sense that it provides a point from which to guide the course of action for those engaged in the most professional of the services rendered by professional accountants.

Perhaps I am more impressed by this event than many others because I was there and witnessed it. The initial exposure of this important document took place at the Institute's annual meeting in 1947. At a technical session presided over by Paul Grady, the then chairman of the Committee on Auditing Procedure, three committee members, Edward Kracke, Alvin Jennings, and John Lindquist presented, respectively, the general or personal standards of the auditor, the standards of field work, and the standards of reporting. To this day, I still consider that afternoon session as one of the most impressive technical presentations I have ever witnessed.

The Committee on Auditing Procedure restudied this document in 1954, for the purpose of adding one reporting standard to require the auditor to provide a clear-cut indication of the character of his examination and the degree of responsibility he is taking whenever his name is associated with financial statements. Hardly another word was changed except to take the term "tentative" out of the title. Practically the identical wording of the standards was carried over into the codification of auditing standards and procedures—issued as Statement on Auditing Procedure 33, in 1963.

Thus, I view the consequences of those milestone events of the late 1930's and early 1940's as providing the financial community today with a set of standards for measuring the quality of the professional auditing services upon which it relies. These same standards provide the auditor with a gospel by which to measure and challenge the truthfulness of his statement on the scope of his examination and his resulting opinion on the financial statements.

In addition to a continuing monitoring of performance standards and their adequacy, the Committee on Auditing Procedure has issued some fifty statements on auditing procedure, to provide guidance in new techniques required



by current developments in accounting and auditing. They have issued numerous booklets on special auditing problems of particular industries.

### **Educational and Professional Development Programs**

Brown and Salquist find it difficult in searching for an ordering of historical milestones, to identify any part of auditing evolution as having resulted from the establishment of articulated goals against which to measure progress. I have very little difficulty in this respect. I can find the goals and the orderly progress not only in the development of auditing standards, but even more evident in the area of education and professional development of the auditor.

The outstanding milestone and landmark events in this area also go back to the restructuring that took place in the early 1940's, when the Institute began shaping its own destinies. Concentrating on the problems of developing an acceptable set of standards with which to measure the training and proficiency of the auditor focussed attention on educational requirements and professional developments.

The milestones that do exist as measuring progress in reaching the goals of well articulated programs have been recognized by many within the profession, but not particularly so by those outside. For example, a truly significant milestone occurred in the early 1950's when the goal was reached of having every state CPA law implemented through the Institute's uniform CPA examination. Today, the same examination is not only used in all fifty states, but all are accorded the Institute's uniform grading services. No other recognized profession can equal this degree of control over its admittance requirements.

Educational developments within the profession in the last twenty years have been sensational. Last year, over 10,000 accountants attended some twenty-five basic training programs, workshops, and courses in special accounting and tax subjects that were offered by the Institute in conjunction with state CPA associations. More than 15,000 accountants attended forty seminars and lecture programs on specialized subjects. Many state CPA associations offer additional programs. Most of the larger firms operate extensive in-house training and professional development programs. On the basis of my own firm's recent experience, I estimate roughly that partners and staff employees of the so-called big eight firms are currently spending in excess of 2,000,000 hours annually in attendance at in-house educational programs, and at least that amount in advance preparation and study for these programs. Several larger firms operate separate school facilities to conduct these training programs. Two states have adopted compulsory continuing educational requirements for maintaining a right to engage in practice as a CPA from year to year, and the Institute Council has recommended adoption of such requirements.

Another milestone in the profession's educational development programs is the publication in 1967 of *Horizons for a Profession*, by Robert H. Roy, and James H. MacNeill. This publication culminated an extensive study by a distinguished commission under the sponsorship of the Carnegie Foundation and the Institute, with an objective of delineating the common body of knowledge which should be possessed by those about to begin careers as CPAs. This study will have continuing effects on refining and coordinating the academic and professional training of future programs.

## **The Legal Environment**

The following session of this symposium will discuss the subject of what the courts are saying to professional accountants in recent cases. The Brown-Salquist paper mentions the milestone cases which have had significant effects on the auditing environment. These are matters of deep concern to all professional accountants. Leaders in the profession and technical bodies in professional accounting organizations are concentrating on programs to alleviate some of the burdensome liability problems facing the profession.

### **Summary**

In summarizing, I refer back to the final era selected by Brown and Salquist—the one they label, “Conflict and Uncertainty,” beginning in the 1970’s. They cite public criticism of accounting principles, current judicial concepts of auditors’ legal liabilities, loss of professionalism in auditing through increasing standardization and uniformity of techniques, and challenges regarding forecasting, interim reporting, and current value reporting—all as the sources of the profession’s conflict and uncertainty. Later in their summary, they mention these same factors as those that are bound to have a disruptive effect on the profession. They also restate their views that auditing has not been characterized by systematic and orderly development and that it has had no well defined path and predetermined goals. They conclude that you could expect little more than chaotic development from auditing since the work itself is chaotic in nature. I find myself in complete disagreement with these conclusions.

Their initial listing of public criticisms of accounting principles as a source of conflict and uncertainty leads me to believe that the authors, together with many other critics of the profession, have let the APB struggles with principles completely overshadow a very orderly evolution and development of auditing. I believe that my outline of the milestones and landmarks of the last forty years present an entirely different picture. I trace a well defined path of development of auditing standards and procedures beginning in 1941. It outlines how numerous hurdles were overcome in achieving predetermined goals.

The progress in educational areas has been effective. The programs and courses offered today make it possible for any man in the profession to obtain the training needed to meet changing conditions of technological and environmental nature. The advent of computers and electronic data processing, the increased use of statistical sampling, extensions of audit services to banks and insurance companies, have all been provided for in training programs of high quality. These developments, together with the Institute’s uniform examination program, have moved the profession in the United States into a position of leadership of the field in the world. It is in this position that I believe we view the current state of affairs.

**The Nature of the Work.** Professional auditing has the same characteristics as most other professional work. The auditor’s time is not his own, it’s his client’s. The client is not interested in how busy he is. He is interested in when his auditor is going to apply his very best professional talent to the company’s problems and meet their deadline in completing the work. This may seem like a chaotic state of affairs to some. The well qualified auditor has learned to live this sort of a life, just as the doctor and the lawyer have. He knows that once he

has accepted an engagement, he has offered himself as one having all the qualifications to perform in accordance with the gospel of generally accepted auditing standards. And when he sits down on the job, he knows full well that he has all of those responsibilities of being independent in attitude and performing with due professional care in planning and supervising and formulating his report on the engagement. There are very few cases that get into the courts where the auditor is flawless in performing according to those personal standards and standards of field work.

I think I have seen most of the significant landmarks in auditing history over the last forty five years that have led us to our present position of a learned profession of well qualified men. If I were to choose one word to describe this evolution in place of the authors' word, "chaotic," it would probably be the word, "stolid."

There *are* uncertainties and deep concern over the current court decisions regarding accountants' liabilities. Quite frankly, I don't know how we could be much better organized than we are in the profession to solve these problems. I believe they will be solved in a manner that will not discredit nor injure the profession's ability to continue performing its important services to the financial community, and to society as a whole.

I see nothing chaotic or disruptive about the trends toward current value reporting, publishing forecasts, questioning the audit scope, and the like. They do involve controversial and critical issues. But I don't view each as a new crisis. I think we are inclined to get into the rut of assuming that a new crisis looms every other day. We have the energy crisis, the ecology crisis, and the current value reporting crisis. Secretary Connally responded to one of these new loomings the other day by saying that we have vast resources of hydrocarbons and he doesn't think we are going to run out of a clean supply of energy for many hundred years. I feel much the same way about the accounting profession. We have vast resources of well organized talent to cope with our problems and I think these resources will not be exhausted before the problems are solved.

If our client's management decides that he needs our professional opinion on his interim financial statements or on his annual forecast of operations, I think we can find a reasonable way to provide the opinion he needs. We have been doing this in isolated situations for as many years as I can remember. I am sure that many will oppose the forecast problem with arguments that we just cannot become soothsayers, just as they said we would have to become appraisers in order to have meaningful contact with physical inventories. We have the capacity needed to formulate the groundrules and train the people to perform, if we are called upon for these additional services.

I don't believe anyone in the auditing profession should have fears about light being shed on the extent of their audit testing and the procedures they employ. There have been some tremendous changes in the last twenty years resulting from more extensive use of statistical sampling, and with learning how to audit through computers. By far the principal purpose of the auditor's tests of detailed transactions, however, is to establish his own opinion as to the adequacy of internal controls for producing reliable financial data. The auditor's review of the internal administrative controls is the basis of his appraisal of the general character of the client's organization and management. All of this bears

heavily on his judgment when issues arise over accounting measurement choices and alternative reporting procedures.

I am glad to see the authors finally conclude with confidence that the auditing profession will become an even more constructive factor in the financial arena. I'm glad that my experience in the auditing arena has left me with more confidence than they have that the profession can do a rigorous job of defining the necessary goals and achieving them.